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SUBJECT: IMF COMMENDS PERU, BUT CHALLENGES REMAIN

REF: LIMA 210

11. (U) Summary: On January 26, the International Monetary Fund (IMF) approved a stand-by agreement with the GOP for 2007-2009 during which the IMF will support the GOP's economic program. The IMF commended the GOP for its prudent conduct of fiscal policy in recent years, which is largely responsible for Peru enjoying its longest period of economic expansion on record, with low inflation, a solid external position (a rising current account surplus with strong foreign investment), and declining indebtedness ratios. However, the IMF noted that the level of poverty in Peru and the structural weakness of the economy remain as challenges. End Summary.

12. (U) A stand-by agreement is significant for Peru as it signals the IMF's support for current macroeconomic policies and that Peru can borrow funds from the IMF providing that Peru "observes specific terms in order to be eligible to receive a disbursement." The new stand-by agreement is the GOP's fourth since 2001. The GOP did not draw on IMF reserves during the three previous stand-by agreements nor did it on the Extended Fund Facility of 1999-2001.

IMF PRAISE FOR GOP  
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12. (U) A key factor in support of the IMF's decision to agree to a stand-by agreement was Peru's recent macroeconomic performance which now has the country "harvesting the results of good economic policies" established over the past several years. The IMF cites high commodity prices and strong domestic demand as key factors in the GOP's economic performance, with prudent fiscal policy playing a major role, expecting that strong growth may materialize even if current high metals prices decline somewhat. The IMF pointed out that Peru's Public Sector debt is estimated to have declined to 31.5 percent of GDP by end-2006, or 15 percentage points below its end-2002 level. Also, inflation declined from 2.9 percent in April to 1.1 percent in December.

IMF IDENTIFIES CHALLENGES: POVERTY AND INFORMAL LABOR  
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13. (U) The IMF Board noted that major challenges remain, including the high rate of poverty (51 percent), regional income disparities, and the still-high dollarization of the economy. Structural reform, the IMF says, is necessary to address poverty, specifically a

reduction in the size of the informal labor market and a concerted effort to improve the flexibility of the labor market. The GOP is currently considering a series of measures to address these labor market issues. Javier Silva Ruete, an IMF Director, emphasized the importance of creating better competition in Peru's labor market and the necessity for creating more employment in the formal sector of the economy. The report also urged the GOP to decisively tackle the high poverty rates, improve tax policy and administration by reducing exemptions, and simplifying the code to broaden the base. They also warned that fiscal decentralization should be implemented cautiously.

#### GOP MINISTER OUTLINES STRATEGIES TO ADDRESS THE CHALLENGES

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14. (U) Luis Carranza, GOP Minister of Economy and Finance (MEF), stated January 29 that the GOP's policies aim to reduce the poverty level from slightly over 50 percent to 40 percent during this administration's term -- ending in 2011. The GOP's economic strategies for poverty reduction will include a substantial improvement in social expenditures and improvement of government investment. The "three pillars" of the GOP's economic plan are institutionalizing macroeconomic discipline; rationalizing public expenditures through reduction of administrative expenses; and reducing economic volatility by maintaining economic growth between 6 and 7 percent.

15. (SBU) Carranza said an integral part of the government's strategy is to develop, in the near future, a tax framework that is efficient and equitable so that more workers can be absorbed into the formal economy through tax simplification. In the meantime, the immediate strategy is to make better use of existing tax revenues and curtail the loss of revenues through special exonerations. Silva Ruete commented that the IMF is willing to provide technical cooperation to assist the GOP in reducing the impact of exonerations on potential tax revenue.

#### COMMENT

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16. (U) The GOP has made steady economic progress as per reftel and the IMF's assessment. Nonetheless, key challenges remain, of which some of the most pressing are reducing poverty, broadening the tax base, and reforming the labor market. Observers, such as former Prime Minister Pedro-Pablo Kuczynski, give the government high marks for its efforts; yet admit that while there are program initiatives and projects, there is no overall plan. The former Prime Minister and Finance Minister under the previous administration recently noted that the current government had inherited an economy in excellent condition, but warned the government that social pressures would increase if the benefits of the country's economic growth were not shared more broadly -- precisely Alan Garcia's campaign platform.

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